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PARTNERSHIP TAXATION FOR THE LIMITED PARTNERSHIP WITH A CORPORATE GENERAL PARTNER—IT CAN BE DONE

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I. INTRODUCTION

One of the most versatile tools the business planner has at his disposal is the limited partnership with a corporate general partner. Basically, the partnership consists of a corporate general partner with limited partners who may or may not own stock in the general partner. Occasionally, there is a non-corporate general partner as well. The advantages of this entity become especially apparent in the areas of real estate investment and development.¹ In most instances, it is desirable for the corporation to hold title to the land and then contribute it to the limited partnership. Under such an arrangement, dower laws which often restrict alienability of land are circumvented.² Since state usury laws generally permit lending institutions to charge higher interest rates to corporations,³ financing often unavailable to individuals becomes available to the corporation. From an investor's viewpoint, the limited liability of stock ownership is often preferable to the unlimited liability of general partnership. However, notwithstanding the advantages of the corporate form of doing business, the limited partnership offers several advantages. The limited partners enjoy the same limited liability as stockholders as long as state laws on limited partnership are followed.⁴ The limited partnership agreement has flexibility not found in the articles of incorporation or corporate by-laws in that the partnership agreement can consider the nature of the assets contributed to the limited partnership and allocate items of income

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1. For a discussion of the tax advantages of this type of entity see Hall, *Use of a Limited Partnership to Invest in Depreciable Realty*, 21 MERCER L. REV. 481 (1970); McGuire, *Limited Partnership: Steps That Can Be Taken to Overcome Problems in the Area*, 34 J. OF TAXATION 235 (1971).

2. See FLA. STAT. § 731.34 (1969), which permits a widow to elect to take one-third of the property owned by her husband at death. Corporate ownership of the land would alleviate this problem.

3. In Florida, the legal interest rate with regard to loans to individuals is 10% and is 15% to corporations. FLA. STAT. § 687.03 (1969).

4. Section 7 of the Uniform Limited Partnership Act provides that: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in control of the business."

and expense in a manner responsive to the contributions of the several partners, both limited and general.⁵ Such an allocation is contingent on the limited partnership being treated as a partnership for tax purposes, as opposed to an association. In the past, the Internal Revenue Service had generally issued revenue rulings granting the desired partnership taxation characterization to the limited partnership. In late 1969, however, the Bureau of National Affairs began to publish "Tidbits" which suggested that the Service had become extremely unwilling to continue to issue favorable rulings.⁶ As a consequence thereof, business planners began to use alternative methods of obtaining the desired results in order to avoid potential tax litigation. It is submitted that careful planning will attenuate the threat of an attack by the Service on a limited partnership with a corporate general partner.

II. THE EFFECT OF STATE LAW

The propriety of a corporation entering into a limited partnership must be determined under applicable state law. The Uniform Partnership Act provides that a partnership is an association of two or more persons to carry on business for a profit,⁷ and that a person is an individual, partnership, corporation or other association.⁸ Although the Uniform Limited Partnership Act does not specify whether a corporation may be a partner, the UPA applies to the ULPA to the extent that the latter remains consistent with the former.⁹ The two acts, when read together, do not seem to prohibit a corporation from becoming a partner, either limited or general. Traditionally, state corporation law had prohibited a corporation from entering into a partnership on the theory that the authority of the board of directors would be substantially curtailed due to the agency relationship among the members of a partnership.¹⁰ However, Florida corporation laws specifically enable a corporation to become either a general or limited partner.¹¹

III. THE "UNOFFICIAL" ANNOUNCED POSITION OF THE SERVICE

Presumably, the Service waited until 1969 to initiate its assault on the limited partnerships since an earlier assault would have been inconsistent with its position with regard to professional associations. The professional association or "P.A." cases dealt with law firms and medical

5. INT. REV. CODE OF 1954, § 704(a). The regulations under § 704 should be examined in order to prevent allocations having no economic substance whose sole purposes are the avoidance or evasion of tax. INT. REV. CODE OF 1954 § 704(b)(2).

6. See notes 17, 19, 20, 23, 24 and 25 *infra* and accompanying text.

7. UNIFORM PARTNERSHIP ACT Part II § 6(1) (hereinafter cited as UPA).

8. UPA Part I § 2.

9. UPA Part II § 6(2).

10. For a discussion of a corporation's common law right to be a partner see Armstrong, *Can Corporations Be Partners?*, 20 BUSINESS LAWYER 899 (1965).

11. FLA. STAT. § 608.13(18) (1969).

offices which incorporated in compliance with state professional corporation laws.¹² The Service lost an early battle in a case involving a group of professionals which complied with regulations governing corporate taxation even though there was no state law which permitted professional corporations.¹³ Subsequent to this decision, the Service enacted a group of regulations pertaining particularly to professional associations,¹⁴ but these regulations were held to be discriminatory,¹⁵ and ultimately the Service acquiesced and abandoned its attack on professional associations.¹⁶

It would have been tactical suicide for the Service to have initiated its attack on limited partnerships while the "P.A." cases were still in litigation because of the dichotomous positions involved. In the former instance, the organizations were being *denied* corporate tax treatment, even though there was compliance with the Treasury's own regulations.¹⁷ In the later instance, organizations were *threatened* with corporate tax treatment, even though the regulations pertaining to limited partnerships had been met.¹⁸

Prior to 1969, the Service had generally granted partnership status to limited partnerships with corporate general partners. In the latter part of that year, the Service evidenced a singular determination to prevent the continued benefit of partnership taxation to limited partnerships with corporate general partners unless those partnerships conformed to certain tests which were mentioned in the Bureau of National Affairs "Tidbits."¹⁹

The initial release²⁰ merely stated that for federal income tax purposes the Service would not issue a ruling on the qualification of a limited partnership as a partnership where the sole general partner was a corporation in which any one of the limited partners was also a shareholder of the corporate general partner. Presumably, this position would extend to situations in which an officer or director of the corporation owns no stock in the corporation, but is a limited partner.

The Service then indicated that it would rule favorably,²¹ if the limited partners owned less than 20 percent of the outstanding stock of the corporate general partner. But there would be no ruling where a limited partner was a director or officer of the corporate general partner.²²

A subsequent release suggested that the Service would rule favor-

12. See generally Reich, *Alternatives to the Professional Service Corporation*, 28 N.Y.U. TAX. INST. 1173 (1970).

13. *United States v. Kinter*, 216 F.2d 418 (9th Cir. 1954).

14. Treas. Reg. § 301.7701-2(h) (1965).

15. *Kurzner v. United States*, 413 F.2d 97 (5th Cir. 1969).

16. Rev. Rul. 70-101, 1970-1 CUM. BULL. 278.

17. See note 13, *supra*.

18. Treas. Reg. § 301.7701-3(b) (1960).

19. Hereinafter referred to as "Tidbits."

20. Tax Management Memorandum 69-05, Tidbit #1.

21. A favorable ruling is, for the purposes of this discussion, one in which the Service will consent to taxing the limited partnership as a partnership.

22. Tax Management Memorandum 69-08, Tidbit #1.

ably where the officers or directors of the corporate general partner held limited partnership interests not exceeding 20 percent of all of the interests in the partnership, provided that the officers or directors did not own stock in the corporate general partner or an affiliated corporation as defined under the SEC rules dealing with affiliated groups.²³

The Service then decided to use the rules of section 1504²⁴ of the Internal Revenue Code in determining what would constitute an affiliated group. The attribution rules of section 318 of the Code²⁵ would also be applied in determining if the stock is owned directly or indirectly by the limited partners.²⁶

The IRS next indicated that a limited partnership would be given a favorable ruling only if the net worth on the books of the corporate general partner was at least \$250,000 or 10 percent of the capitalization of the limited partnership, whichever was greater. If there was more than one general partner, the net worths may be combined. This test is said to be a general test which is applied even if the limited partnership does not have continuity of life, centralized management, or free transferability of interests.²⁷ The net worth test was modified to eliminate the flat \$250,000 or 10 percent requirement so that the corporation needed a net worth equal to 15 percent of the partnership capital if the capital was less than \$1,666,667, and 10 percent if the partnership capital exceeded \$2,500,000. A sliding scale would be used if the capitalization fell between these two parameters.²⁸

The most recent unofficial report indicated that both the 20 percent ownership test and the net worth test must be met in order for a favorable ruling to be forthcoming.²⁹ A Letter Ruling issued on May 18, 1971, supports the position that the Service does indeed plan to follow the criteria in the unofficial releases mentioned.³⁰ On the other hand, all of the above

23. Tax Management Memorandum 69-19, Tidbit #1.

24. INT. REV. CODE OF 1954, § 1504 basically refers to brother-sister corporations with 80% common control.

25. INT. REV. CODE OF 1954, § 318(b) specifically provides that its attribution rules will apply only where explicitly invoked by statute. Therefore, the propriety of using § 318 is highly suspect.

26. Tax Management Memorandum 69-21, Tidbit #1.

27. Tax Management Memorandum 69-26, Tidbit #3.

28. Tax Management Memorandum 70-10, Tidbit #1.

29. *Point to remember* #10, 24 TAX LAWYER 605 (1971).

30. The following is a reprint of the relevant portions of the letter ruling, as was initially given to the Prentice-Hall Tax Service.

In accordance with your request I enclose herewith a portion of a private ruling issued by the Internal Revenue Service on May 18, 1971, holding that the organization to whom the ruling was issued qualified as a limited partnership subject to certain conditions. The enclosed language is a verbatim extract of the conditions imposed by the Service on said organization's continued status as a limited partnership for tax purposes.

I trust you will find this information useful. [Letter to Prentice-Hall, Inc.]

Conditions Excerpted from Letter Ruling

* * * * *

1. That the investing limited partners will not own directly or indirectly, indi-

releases appear to be totally inconsistent with a letter this author received from the Internal Revenue Service.³¹

IV. THE SERVICE'S OFFICIAL POSITION AS STATED IN THE REGULATIONS

Prior to these releases, the Service's position with regard to limited partnerships was thought to be categorically specified in the regulations. A limited partnership would be treated as a partnership for tax purposes, unless using the principles set forth in Treasury Regulation section 301.7701-2 (1960), the organization more clearly resembled a corporation than a partnership.³² In order to more clearly resemble a corporation, the organization must have at least three of the four corporate characteristics which were initially articulated in *Morrissey v. Commissioner*³³ and have subsequently been adopted by the Treasury.³⁴ The four characteristics considered are continuity of life, free transferability of interests, centralized management and limited liability. Two of the four, continuity of life and free transferability of interests, are basically creatures of contract law, thus, their non-existence can be insured by proper draftsmanship.

If the death, retirement, or insanity of a general partner of a limited partnership causes the dissolution of the partnership, continuity of life

vidually or in the aggregate, more than 20 percent of the stock of the corporate general partner or any of its affiliates as defined in section 1504(a) of the Code.

2. If the corporate general partner has an interest in only one limited partnership and the total contributions to that partnership are less than \$2,500,000, the net worth of the corporate general partner at all times will be at least 15 percent of such total contributions of \$250,000, whichever is the lesser; if the total contributions to that partnership are \$2,500,000 or more, the net worth of the corporate general partner at all times will be at least 10 percent of such total contributions. In computing the net worth of the corporate general partner, for this purpose, its interest in the limited partnership and accounts and notes receivable from and payable to the limited partnership will be excluded.

3. If the corporate general partner has interests in more than one limited partnership, the net worth requirements explained in the preceding paragraph will be applied separately for each limited partnership, and the corporate general partner will have at all pertinent times (exclusive of any interest in any limited partnership and notes and accounts receivable from and payable to any limited partnership in which the corporate general partner has any interest) a net worth at least as great as the sum of the amounts required under (2) above for each separate limited partnership.

31. The following excerpt is from a letter dated April 28, 1971, written to the author from Lester W. Utter, Chief, Individual Income Tax Branch:

This is in reply to your letter of February 17, 1971 in which you request information and ask certain questions concerning the classification of limited partnerships for Federal income tax purposes.

The Internal Revenue Code prescribes certain categories, or classes, into which various organizations fall for purposes of taxation. These categories, or classes, include associations (which are taxable as corporations), partnerships, and trusts. The tests, or standards, which are to be applied in determining the classification in which an organization belongs (whether it is an association, a partnership, a trust, or other taxable entity) are determined under the Internal Revenue Code. Sections 301.7701-2 through 301.7701-4 set forth these tests, or standards.

32. Treas. Reg. § 301.7701-3(b)(1) (1960).

33. 296 U.S. 344 (1935).

34. Treas. Reg. § 301.7701-2(a)(1) (1965).

does not exist.³⁵ Although the regulations do not appear to contemplate a corporate general partner, since the bankruptcy of any member of the organization will cause the dissolution of the organization,³⁶ this possibility of dissolution ought to preclude continuity of life. Even if the partnership agreement provides that the business will be conducted by the remaining members of the partnership in the event of the death or withdrawal of any member, such a provision will not establish continuity of life if death or withdrawal of a member will cause dissolution under local law. Thus, there may be a dissolution of the organization and no continuity of life even though the business is continued.³⁷

Under the Uniform Limited Partnership Act a dissolution will occur unless all the members of the partnership consent to the continued operation of the business or the right to continue the business is stated in the certificate of limited partnership.³⁸ Therefore, unless a specific provision is included in the partnership agreement, continuity of life will not exist. Continuity of life may also be avoided by specifically including a provision permitting the organization to be terminated by any member at any time. But all of this verbiage seems superfluous in light of the unequivocal statement in the regulations that a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act lacks continuity of life.³⁹

The corporate characteristic of free transferability of interest will be avoided if the limited partnership agreement provides that no member of the limited partnership can transfer his interest to a non-member unless all of the members consent to the transfer.⁴⁰ Prevention of free transferability may also be accomplished by a provision requiring a limited partner or his estate to sell the interest either to the general partner or to the other limited partners, if such interest is to be sold at all.⁴¹ However, care must be taken to avoid a mandatory sale at death in order to prevent bunching of income under section 706(c).⁴²

Like continuity of life, then, the characteristic of free transferability of interests is largely a matter of contract law and, according to the regulations, if neither of these characteristics exists, the limited partnership will be taxed as a partnership.⁴³ But since the planner may want his entity to have either free transferability of interests or continuity of life, the characteristics of centralized management and limited liability will be examined in order to provide maximum planning flexibility.

35. Treas. Reg. § 301.7701-2(b)(1) (1965).

36. *Id.*

37. Treas. Reg. § 301.7701-2(b)(2) (1965).

38. UNIFORM LIMITED PARTNERSHIP ACT § 20 (hereinafter cited as ULPA).

39. Treas. Reg. § 301.7701-2(b)(3) (1965).

40. Treas. Reg. § 301.7701-2(g) example 2 (1965).

41. Treas. Reg. § 301.7701-2(e)(2) (1965).

42. See Treas. Reg. § 1.706-1(c)(3)(vi) example 2 (1956).

43. See note 32 *supra* and accompanying text.

The regulations provide that in determining whether an organization has centralized management, local law will govern.⁴⁴ This raises a difficult problem with respect to a limited partnership in states where the Uniform Limited Partnership Act is in force since centralized management generally becomes an issue when creditors of the partnership seek to remove the protective cloak of limited liability from the limited partners.⁴⁵ The paucity of case law in this area virtually precludes predictability and consequently renders the rule of *Bosch v. Commissioner*⁴⁶ inapplicable, especially in states where the issue has not arisen. The limited number of cases which have been decided should, however, give the reader some sensitivity to the problems involved.

In *Holzman v. De Escamilla*⁴⁷ there was a suit by a trustee in bankruptcy of a limited partnership against the defendant and two limited partners to determine if the limited partners were general partners for the purposes of liability. The partnership was in the farming business; the limited partners determined what crops would be planted. Perhaps more significant is the fact that the checking accounts required the signatures of any two of the three partners, limited or general. Thus, the limited partners had absolute control over the expenditure of funds in the business, because the general partner needed the signature of one of the limited partners in order to draw a check, and therefore either of the limited partners could effectively veto any expenditure by the general partner. One would think that these two powers would be sufficient to remove the cloak of limited liability from the two limited partners. In addition, the limited partners forced the general partner to resign. The court held that the limited partners had exercised sufficient control over the business to be held liable as general partners.

*Rathke v. Griffith*⁴⁸ explored the effect of reliance by a person seeking to destroy the protection of a limited partnership. The limited partnership agreement provided that the affairs of the partnership should be handled by a three member group that bore a striking resemblance to a board of directors. The defendant was elected to this "board," signed a lease for the partnership, a power of attorney for the partnership along with the general partners, and also signed two warranty deeds for the partnership. The court held that since there was no reliance by the plaintiff on the fact that the defendant appeared to be a general partner, the defendant would not be categorized as a general partner.

Silvola v. Rowlett,⁴⁹ decided four years after *Rathke*, gives additional

44. Treas. Reg. § 301.7701-2(c)(4) (1965) alludes to compliance with the Uniform Limited Partnership Act.

45. ULPA § 7.

46. 387 U.S. 456 (1967) (Only the decision of the highest state court will be regarded for federal tax purposes.)

47. 86 Cal. App. 2d 858, 195 P.2d 833 (1948).

48. 36 Wash. 2d 954, 218 P.2d 757 (1950).

49. 129 Colo. 522, 272 P.2d 287 (1954).

insight into those acts of a limited partner which do not constitute control of the business. The defendant, the limited partner, for a few months acted as foreman of the general partner's auto repair shop. The general partner had sole control of the bank account, made all deposits, secured all loans, executed all chattel mortgages in connection with the business and was the only one authorized to draw on the checking account. The court held that sufficient control over the management of the business had not been exercised by the limited partner to categorize him as a general partner.

*Grainger v. Antoyan*⁵⁰ offers a few more characteristics which do not brand the limited partner with the "control taint." In 1950, the defendant became sales manager of an auto concern; he had no authority to employ or discharge personnel or to accept trade-ins on cars, unless the trade-ins complied with a specific, fixed formula. In 1951, he was authorized to co-sign checks. However, this was only allowed when his employer was out of town. Additionally, he had no authority regarding the service department. Shortly thereafter, he became a limited partner in the business, and later, as a result of an amendment to the limited partnership agreement, was required to contribute \$1,000 to the partnership. At no time did the defendant have control over the extension of credit. The court held that there was no control and hence no unlimited liability with respect to the limited partner.

In another case, a limited partnership agreement provided that the general partner could exercise various financial powers only when he acted jointly with the general sales manager of the partnership. The father of the beneficiaries of a trust was the general sales manager; the trustees of the trust were limited partners in the partnership. If the general sales manager's employment was terminated, the trustees were required to sell their interest to other limited partners. The court rejected the contention that because the trust beneficiaries were the children of the general sales manager, the trustees were general partners. Although the case does not clearly so state, it suggests that for the purposes of state law, a limited partner cannot become a general partner by some form of attribution.⁵¹

The most recent case dealing with the area of "control" is *Vulcan Furniture Manufacturing Corp. v. Vaughn*.⁵² In this case, a limited partnership consisted of two general partners and one limited partner. One of the general partners died and the other general partner purchased his interest. The partnership failed to renew the limited partnership certificate on the death of a partner, as required by state law.⁵³ Plaintiff argued that the failure to renew the certificate caused the limited part-

50. 48 Cal. 2d 805, 313 P.2d 848 (1957).

51. *Plasteel Prod. Corp. v. Holman*, 271 F.2d 354 (1st Cir. 1959).

52. 168 So.2d 760 (Fla. 1st Dist. 1964).

53. FLA. STAT. § 620.31 (1969).

nership to become a general partnership, rendering the defendant limited partner liable as a general partner. The court held that a *de facto* limited partnership existed, analogizing it to the situation where a *de jure* corporation becomes a *de facto* corporation for failure to file an annual report and pay a corporate stock tax. One can only speculate as to whether the doctrine of "*de facto* limited partnerships" is a valid one. However, since the defendant exercised no control over management, the court had little alternative if it wanted to prevent unlimited personal liability.

If there are no potential problems under state law, the regulations provide that centralized management means a concentration of continuing exclusive authority to make independent business decisions on behalf of the organization which do not require ratification by members of the organization.⁵⁴ Centralized management will not exist when the centralized authority is merely to perform ministerial acts as an agent at the direction of a principal.⁵⁵ This statement should negate the impact of the BNA Tidbit release concerning the stock ownership limitations, since the greater the number of limited partners who are officers, directors or stockholders of the general partner, the more diffuse the management becomes. By attempting to minimize the participation of limited partners in the corporate general partner, the Service is defying its own regulations. Logically, its position should be that unless participation in management exceeds a certain percentage,⁵⁶ centralized management will exist. Such a position would be consistent with I.R.S. regulations.

The examples in the regulations lend credence to the foregoing contention and consequently offer suggestions for planners. Centralized management does not exist if the agreement provides that management of the organization be vested exclusively in an executive committee of four members elected by all the members of the organization, because the agreement will not be effective against outsiders who had no notice of it.⁵⁷ However, centralized management will exist if, under local law, no one acting without the authority of the committee has the power to bind the organization by his acts.⁵⁸ If the elected officers of an organization perform only ministerial functions such as presiding at meetings and carrying out the directions of the members, centralized management does not exist.⁵⁹ If the general partner has exclusive authority to manage the affairs of the organization, but can only act with the unanimous consent of all of the members, centralized management does not exist.⁶⁰

54. Treas. Reg. § 301.7701-2(c)(3) (1965).

55. *Id.*

56. The 80% test of INT. REV. CODE OF 1954, § 368(c) is suggested since the issue of control by limited partners of the general partner is analogous to the areas where control arises in Sub-chapter C.

57. Treas. Reg. § 301.7701-2(g) example 2 (1965).

58. Treas. Reg. § 301.7701-2(g) example 5 (1965).

59. Treas. Reg. § 301.7701-2(c)(3) (1965).

60. *Id.*

Since the management of the limited partnership might be impaired if the corporate general partner is required to obtain approval of the limited partners before performing any managerial functions, it is suggested that the limited partnership agreement state that the corporate general partner has exclusive control over the day-to-day affairs of the organization but must obtain the approval of a high percentage of the limited partners in order to perform stated functions such as borrowing money or mortgaging property. Such a construction should still prevent centralized management.

The theory behind the regulation dealing with centralized management appears to be that the more concentrated management becomes in a relatively small group of members of the organization, the more closely that group resembles a corporate board of directors. As a consequence, the management characteristic is more emblematic of a corporation than of a partnership. Strangely enough, there are inherent and illogical contradictions in the regulations. For example, the regulations provide that limited partnerships corresponding to the Uniform Limited Partnership Act generally do not have centralized management unless substantially all of the interests (presumably proprietary interests) are owned by the limited partners.⁶¹ It has been shown that just the opposite is true. A limited partnership subject to the Uniform Limited Partnership Act will not have centralized management as long as substantially all of the interests are owned by the limited partners.⁶²

Since centralized management tends to disappear as the number of limited partners taking part in management increases, the proposed use of the attribution rules of section 318⁶³ is deleterious to the Service's already ill-conceived opinion and ought not to be regarded as a threat to the planner.

With respect to the limited liability, the regulations provide that personal liability will not exist with respect to the general partner when he has no substantial assets other than his interest in the partnership which could be reached by a creditor of the organization.⁶⁴ This statement contradicts the net worth test suggested in the BNA releases⁶⁵ in that there is no correlation between the net worth of a corporation and its capital interest in the limited partnership.

Assume that corporation X has assets of \$25,000,000, liabilities of \$23,000,000 and a net worth of \$2,000,000. Corporation Y has assets of \$2,000,000, liabilities of \$1,000,000 and a net worth of \$1,000,000. If in the alternative, each was the general partner in a limited partnership capitalized at \$20,000,000, corporation X would pass the IRS test while corporation Y would not. Yet, from a creditor's perspective, a borrower

61. Treas. Reg. § 301.7701-2(c)(4) (1965).

62. See notes 47 and 53, *supra*.

63. See note 26, *supra*.

64. Treas. Reg. § 301.7701-2(d)(2) (1965).

65. See notes 27 and 28, *supra*.

with a net worth equal to 50 percent of assets is far more desirable than a borrower whose net worth equals eight percent of its assets. If the Service chooses to be the paladin of the limited partnership's creditors, logic dictates that since the general partner is personally liable, the corporation's balance sheet should be analyzed independently of the capitalization of the partnership.

The examples in the regulations suggest that this was what the Service had initially considered. In one example, the general partners contributed a total of \$150,000 to a limited partnership whose total capitalization was \$5,150,000. But since the facts alluded to the general partners having sufficient means to satisfy the obligations of the organization, no limited liability was held to exist.⁶⁶ In a second example, the general partners contributed a total of \$300,000 to a limited partnership capitalized at \$5,300,000 but since the general partners were personally capable of assuming substantial obligations of the organization, no limited liability existed.⁶⁷ Looking to the assets of the general partners, the examples concluded that contributions to the limited partnership of 2.9 percent and 5.6 percent of the total capitalization of the limited partnership was sufficient to protect the claims of creditors; no mention was made of the respective net worths of the general partners with respect to the capitalization of each partnership.

The regulations suggest tests other than the net worth test. If the general partner is merely an agent of the limited partners, then personal liability exists with respect to the limited partners,⁶⁸ but will not exist with respect to the general partner when acting as the agent of the limited partners.⁶⁹ These two rules suggest that a limited partnership, whose general partner purportedly has unlimited liability, will be converted into a limited partnership with the limited partners having unlimited liability. In either event, however, at least one member of the organization will be personally liable to creditors and, consequently, unlimited liability must exist in a limited partnership.

It has been shown that if the limited partners exercise too much control in the management of the corporate general partner, and hence in the partnership, the limited partners will no longer enjoy limited liability under state law.⁷⁰ A cross indemnity agreement between the corporate general partner and the limited partners, or perhaps a triangular indemnity agreement if there is also an individual general partner, will protect the individuals and still not destroy the unlimited liability traditionally inuring to the general partner.⁷¹

66. Treas. Reg. § 301.7701-3(b)(2) example 2 (1960).

67. Treas. Reg. § 301.7701-3(b)(2) example 1 (1960).

68. Treas. Reg. § 301.7701-2(d)(2) (1960).

69. *Id.*

70. See notes 45, 47-53, *supra*.

71. Treas. Reg. § 301.7701-2(d)(1) (1960).

V. POSSIBLE PLANNING TECHNIQUES

Basically, five possibilities exist regarding the organization of a limited partnership with a corporate general partner. Each of these options will be discussed in light of potential IRS attacks, with suggestions as to how to best avoid unfavorable Service reaction.

(1) Assume that all of the limited partners are stockholders, directors or officers of the corporate general partner and that the general partner has no officers, directors or stockholders who are not limited partners. Since it has been shown that the Service's unofficial position cannot withstand the scrutiny of both logic and the regulations, the only avenue of attack available to the Service is that the entire entity is a sham. It could be argued that the limited partnership is a sham and that all of the limited partners are to be considered stockholders of the corporate general partner. The net effect would be that all of the profits and losses of the limited partnership, regardless of any contractual allocation of the partnership agreement, would be attributed to the corporation. This type of attack would be most telling when tax shelters are available to the limited partners as partners, but not as stockholders of the corporate general partner.

If, in the alternative, the Service argued that the corporate general partner was a sham, the limited partnership would be treated as a corporation and the limited partners would be regarded as stockholders; the ensuing tax consequences would be the same as previously discussed.

The third option available to the Service is to permit the entity to remain intact, but to treat the limited partnership as a corporation and the corporate general partner as a subsidiary. In the opinion of the author, this ploy would impose a triple tax on the limited partner-stockholders. Each limited partner would be taxed as a stockholder of the limited partnership; the corporate general partner would be taxed as a stockholder; and the stockholders of the corporation, who are the limited partners, would be taxed as stockholders of the subsidiary corporate general partner.

In attempting to thwart any of the above attacks, the planner has one of two options. He can rely on logic and the regulations, or he can rely on case law. It has already been shown that if the partnership agreement expressly negates two of the four corporate characteristics mentioned in the regulations, the entity should be taxed as a partnership. The characteristics to be avoided will depend on the needs of the planner and his clients. However, if the planner wishes to create continuity of life or free transferability of interests at the expense of centralized management, care should be taken to avoid the establishment of small executive or management committees. If the need for flexibility requires the existence of these committees, the corporate by-laws should expressly comply with the examples cited in the regulations.⁷²

72. *Treas. Reg. § 301.7701-2(g) examples 2-7 (1965).*

Since the Service apparently intends to disregard its own regulations, the achilles heel of the sham argument lies in a single case, *C. W. Kingbay*.⁷³ In that case, the petitioner and his wife formed a limited partnership with a corporate general partner, Kingbay Properties, Inc. The articles of limited partnership required each limited partner, i.e., the petitioner and his wife, to contribute \$100.00, and additional contributions of cash or other property were permitted. Profits and losses were to be shared in the ratio of capital contributions and the business of the partnership was to be managed by the corporate general partner. The corporation had capitalization of \$1,000.00, which was contributed by the petitioner, who was the president of the corporation. His wife was secretary-treasurer.

The limited partnership was formed for the purpose of constructing apartment buildings. In April, 1959, three months after the partnership was formed, the articles were amended to require the general partner to become a limited partner and to contribute \$100.00. The petitioner and his wife each contributed an additional \$2,450.00. Their contributions in subsequent years were as follows:

1962—contributions of each totalled \$ 8,450.00

1963—contributions of each totalled \$19,450.00 (cumulative)

1964—contributions of each totalled \$29,950.00 (cumulative)

In 1958, 1959 and 1960, the partnership purchased land and constructed apartments. Although the partnership was the purchaser and owner of the land and buildings, the mortgage deeds and notes were executed by the general partner in order to obtain financing for the buildings. There was no disclosure in the notes or mortgage deeds that the limited partnership owned the properties. As of December 31, 1959, the outstanding mortgages were \$240,134.62; one year later the mortgages had increased to \$832,698.36.

During the period between 1958 and 1960, the petitioner made the following loans to the corporation:

1958—\$ 32,511.57

1959—\$598,691.21

1960—\$412,940.76

most of which were repaid as follows:

1959—\$259,842.40

1960—\$690,861.35

These loans were carried on the books of the corporation as current liabilities and were treated in a similar way on the returns filed with the IRS.

From these facts, it should be apparent that many of the elements of a sham were present. The corporate general partner was grossly undercapitalized in that it had initial capital of \$1,000.00 while holding prop-

73. 46 T.C. 147 (1966).

erty subject to mortgages of over \$800,000.00, and having borrowed over \$1,000,000.00 from one of its two stockholders who happened to be husband and wife. The general partner was completely controlled by the limited partners. Moreover, neither of the limited partners was personally liable for any of the debts, and the general partner could not be personally liable because the debts were secured by land and buildings. Apparently, the sole purpose behind the structure of the Kingbay organization was the minimization of taxes. However, the Service refused to attack the entity. Instead, the Service successfully defended the entity from an attack by its creators. Had the corporate shell been disregarded, as the taxpayers argued it should have been, then the individual stockholders, not the corporation, would have owned the mortgaged property. Section 752(c) provides that when property is subject to liabilities, those liabilities are treated as liabilities of the owners of the property. Since the partners would have owned the property as individuals, the liabilities would have "belonged" to them. Although a limited partner cannot increase his basis by assuming liabilities which would exceed his basis, the regulations do permit a limited partner to increase his basis if he owns property subject to a liability.⁷⁴ Had the taxpayers prevailed in the Tax Court, the corporate shell would have been disregarded and their bases would have been increased sufficiently to absorb the losses of the limited partnership. The losses then could have been used to offset \$22,493.40 of non-partnership income.

In effect, the thrust of the IRS argument was that the corporate entity must be respected; the limited partnership must be respected; and the limited partners and stockholders must be treated separately for tax purposes, notwithstanding the fact that the limited partners and stockholders are the same individuals.

Evidently, the Service failed to attack a sham solely because to do so would have produced less revenue than to have sustained the sham. However, it is conceivable that had the Kingbay entity been passing accelerated depreciation on to the limited partners, while retaining the earnings of the real estate operation in the corporation, the Service would have contended that the taxpayers had constructed an egregious sham solely for the purpose of avoiding taxes. An equally interesting question is how Kingbay would have been treated under the ULPA. Since the limited partners exercised considerable control over the general partner, section 7 of the ULPA might be invoked to convert the limited partners into general partners, at which point there would be neither limited liability nor centralized management. Therefore, it appears that an entity similar to Kingbay is almost impervious to the sham argument should the Service choose to litigate. But the planner must be warned that Kingbay does not grant his entity immunity from attack; the case only offers a defense.

(2) When all of the limited partners are stockholders but not all of

74. Treas. Reg. § 1.752-1(e) (1956).

the stockholders are limited partners, the rules applicable to situation (1) should apply since the only variable is the existence of non-limited partner stockholders, and these individuals will be taxed as stockholders regardless of how the Service attacks the limited partnership.

(3) When all of the stockholders are limited partners but not all of the limited partners are stockholders, the success of any IRS attack will depend on the relative number of limited partners running the general partner. The smaller the percentage of limited partners who are stockholders, the greater the chances of centralized management existing. An additional problem arises with respect to the limited partners who are not stockholders if centralized management does exist, and as a consequence thereof, the limited partnership has more corporate characteristics than noncorporate ones. The partnership will then be taxed as a corporation and the limited partners who are not stockholders will be taxed as stockholders even though they are not deriving the same benefits as the limited partners who are stockholders. This can be avoided by negating either centralized management or two of the other corporate characteristics mentioned above.

(4) When only some of the limited partners are stockholders and only some of the stockholders are limited partners, the tax consequences should be analogous to those occurring when all of the stockholders are limited partners but not all of the limited partners are stockholders.

(5) When none of the limited partners is a stockholder, the planner will have complied with the Service's unofficial position and should have nothing to fear.

VI. CONCLUSION

Presently, the only certain way for a limited partnership with a corporate general partner to be taxed as a partnership is compliance with the criteria mentioned in the BNA releases. The planner must be advised that non-compliance with the "Tidbits" is an invitation to litigation which ought to be accepted, if at all, only when the circumstances are such as to insure the greatest possibility of victory. However, the tax practitioner who is confronted with an already existing limited partnership with a corporate general partner has no alternative with respect to planning and must posit those arguments which would best serve the interests of his client. Specifically, the criteria articulated in the "Tidbits" will not withstand the scrutiny of logic. In addition, the taxpayer ought not to be penalized as a result of his adherence to the rules set forth in the regulations. Lastly, assuming that the Internal Revenue Service relies on the sham argument, the Service's position should logically fail in that the limited partnership with a corporate general partner would then be converted into a general partnership which would lack both centralized management and limited liability under state law.⁷⁵

75. See note 4, *supra*.